United States Senate

WASHINGTON, DC 20510

April 14, 2005

Senator Pete V. Domenici
Chair, Committee on Energy and Natural Resources

Senator Jeff Bingaman
Ranking Minority Member, Committee on Energy and Natural Resources

Senator Charles E. Grassley
Chair, Committee of Finance

Senator Max S. Baucus
Ranking Minority Member, Committee on Finance

RE: U.S. Petroleum Refining Capacity

Dear Senators Domenici, Bingaman, Grassley and Baucus:

As you well know, passage of comprehensive energy legislation is of vital importance to out nation. While an abundant supply of clean energy is a national priority, we realize that gaining consensus on broad energy policy is a most difficult and challenging task. We extend our sincere appreciation to you for your leadership and ongoing efforts to address the critical energy needs of the country through sound energy and tax legislation.

As you develop an energy bill this Congress, *we urge you to specifically consider measures to encourage investment in new petroleum refining capacity, reliability, and efficiency*. Domestic gasoline, diesel, and jet fuel production strains to meet demand. Supply and price problems become especially acute when a refinery goes down unexpectedly. Fuel commodities are essential to the public, the transportation sector, our nation's economy, and our national security.

On June 22, 2004, in response to tight refined product supply, Secretary of Energy Spencer Abraham asked the National Petroleum Council (NPC) to study the adequacy of U.S. refining capacity. The recently completed NPC report is the most current, detailed assessment on U.S. refining and contains the following observations:

- U.S. refining capacity has grown since 2000, but *the rate of the growth has slowed* in recent years. Capacity growth is not keeping up with demand growth for refined products such as gasoline and diesel.
- Historic profitability and return rates for U.S. refining are lower than other segments of the petroleum industry and *are lower than the average of the*

S&P 500 companies. These modest long-term returns on refining investments have impeded investment in new capacity.

- *The number of operating refineries in the U.S. has steadily declined* from more than 300 in 1980 to 149 today. No new refinery has been built in the U.S. since the mid-1970's. Many refineries have irretrievably closed.
- Future *growth in U.S. refining capacity is expected to come from expansions of existing facilities* rather than new refinery construction.
- The extraordinary investment required to concurrently comply with several major new regulations U.S. refiners now face has reduced the amount of capital left for capacity expansion.[1]

To address capacity concerns, the NPC study makes several useful observations. One of these is to adjust the depreciation schedule for refining assets:

> *"...Adjusting the depreciation schedule for all refining equipment to five years from the current ten years, consistent with the treatment of process equipment in other manufacturing industries, would have a positive impact on expansion investment economics. This action would reduce the capital recovery period for investment in refining equipment, helping to offset the historically low returns in the refining/marketing business that have hindered investment in capacity expansion."*[2]

This concept is worth exploring. We support a further assessment of the benefits and costs of such action, particularly in view of the fact that U.S. refining has been required to depreciate capital spending over a long 10-year period versus many manufacturers that depreciate over shorter 5 to 7 year periods.[3] It would appear that a modification would reduce the capital recovery period for refinery investments without significantly altering tax revenues across a 10-year time frame. If adjusting depreciation schedules will promote investment in U.S. refining, it deserves to be included in the energy package.

Energy legislation affecting the oil industry often focuses on upstream activities, such as exploration and production, but overlooks refining. While Congress recently passed measures to help small refiners comply with ultra low sulfur diesel regulations via immediate depreciation and/or tax credits, such action was limited to a specific fuel and a limited class of refiners.

After review, if accelerated depreciation for U.S. refining is found to have merit, we favor targeted adjustments. For example, shorter depreciation times should not apply in instances of mergers of acquisitions where depreciation schedules simply recycle. Also, to encourage refinery expansion now, we favor a sunset period for accelerated depreciation. These kinds of provisions would help minimize the cost of the measure.

We would look with favor on a depreciation adjustment for the following kinds of refining investments:

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[1] The NPC study also addresses other U.S. refining issues such as regulatory uncertainty, inventory trends, MTBE, product imports, etc.

[2] *Observations on Petroleum Product Supply*, National Petroleum Council, December 2004, pg I-27.

[3] We understand the 10-year depreciation schedule for the U.S. refining industry has been in effect since 1962.

- Bona fide construction and installation of new or used refining equipment that increases a refinery's capacity to make more gasoline, diesels, and jet fuel.
- Process units designed to handle crude slates and refining streams that are difficult and expensive to treat (i.e., heavy, sour, synthetic, poor quality crudes, etc.) but that yield more gasoline, diesels, and jet fuel.
- Refining units designed to treat feedstocks where upstream production tax incentives exist or are part of energy legislation (e.g., shale oil, etc.).
- Non-economic capital investments to meet federal requirements designed to improve the environment.

We hope you will agree that this matter deserves extended attention and review. *We believe an energy bill would be incomplete if it did not address the significant and fundamental problem of inadequate refining capacity and investment in the United States.* We look forward to working with you to develop energy legislation that addresses this important concern.

Sincerely,

David Vitter

Jim DeMint